The Origination and Distribution of Intellectual Property and Implications for Growth

‘We think of it, we build it, we buy it.’ This all works nicely until the economy reaches its speed limits and potential. Then the economy overheats and prices rise more quickly. The limits of an economy can be extended by trade and specialization where productive capacity is exported to areas or countries with cheap labour to bring down costs and relieve capacity constraints.

‘We think of it, you build it, we buy it.’ For the last 30 or so years, this has been what the US economy has effectively done. This outsourcing of manufacturing has allowed the US economy to grow with lower inflation and higher productivity than it otherwise would have as the US effectively focused on high value added activities and delegated the lower value added activities. This approach, however, requires some transfer of intellectual property from the idea originating nation to the outsource producing nation. The impact it has on the originating nation’s long term potential growth rate has well mitigated this cost. But there are other costs. The outsourcing of manufacturing means a widening trade deficit, a weaker currency and the need to finance an ever widening current account deficit. The need to keep vendor financing costs low can lead to artificially low interest rates leading to over borrowing and rising asset and real estate prices with unsustainably high debt levels. This came to a head in 2008.

Since the financial crisis, the US economy has slowed, even in recovery. And costs are rising in China and the emerging markets where the US outsources its manufacturing. Now, productive capacity is being repatriated as the cost advantages have receded due to lower employment costs at home, lower overall costs of having production closer to home and rising costs of freight and production abroad. This is a return to the ‘We think of it, we build it, we buy it’ model, although some things have changed.

As China has prospered by being the factory of the US, it has come to be a significant source of demand as well. From 2011, consumption as a share of economic growth has grown to 55%. The model that may evolve could be described as ‘We think of it, we build it, we all buy it.’ This could bode well for the world economy. For one, it would reverse the lopsided flow of goods and capital. It would encourage global growth, emerging market consumption and developed world savings and debt reduction. One area would continue to be out of balance. Intellectual property. While China has seen a surge in patent applications the Chinese have yet to demonstrate their abilities in inventing original goods and services and commercializing them. So far China’s efforts appear to be in be in the acquisition of intellectual property rather than in its origination. They do this through blatant copying, formalized IP transfer contracts and corporate acquisition.

The demographic gains have mostly been reaped in the emerging markets. Capital flows more freely now than ever before. The last factor in long term potential growth is the intellectual property, the technology set, of the economy. China and the other emerging economies have long relied on IP transfer as part of the bargain, granted a grand and complex bargain. but difficult times at home have led to rising productivity and falling costs in developed markets. In order to maintain growth rates, or even to not have them shrink too drastically, China and the other EMs have to increase innovation.

What can they do to introduce balance to the world? Emerging markets need to develop their own intellectual property and IP generating capabilities. It needs to do this by building world class research facilities and attract foreign talent as well as encourage local talent.

Here emerging market countries have an opportunity if not an advantage. Tax.

Most of the developed markets’ governments are either fiscally stressed or distressed. Their herd instinct has been to raise taxes and tax more aggressively. Some countries have taken advantage over this grave myopia or strategic error by welcoming the rich and their capital. This is itself clever but a little myopic. A grander strategic vision would be to provide tax sanctuary to the brains and inventors of tomorrow. If not, then when the pendulum swings and productive capacity returns to developed markets, whether to soak up the unemployed or because automation allows production to be more geographically targeted to final demand, the consequences for the world’s manufacturing centres may be dire.